Sparinvest

Monthly comment for September

September dominated by higher volatility and lower risk tolerance

Financial markets saw higher volatility and lower risk tolerance in September. The increased volatility was probably related to rising covid-19 cases Europe. The same trend was recorded when the number of case rose in the U.S. in June and July. Global equities lost 2.7% according to MSCI ACWI stated in local currencies. Translated into DKK, this was a decrease of 1.5%. Risk premiums (i.e. investor's reward for taking risk) rose on European corporate bonds. Credit spreads (i.e. the yield pick-up on investment in a corporate bond relative to a government bond) of European investment grade and high-yield bonds widened by 4 basis points and 26 basis points, respectively, in September. For the two assets, this led to excess returns of -0.1% and -0.8%, respectively, relative to comparable government bonds in the previous month. The Danish 10Y government bond yield fell marginally by -0.3% to -0.4% in September.

New normal approach to coronavirus – positive momentum intact

The Western economies have been reopening since the beginning of May. The coronavirus continues to impact this process. European trends share some of the characteristics of the trends seen in the U.S. in the early summer. The key element is the number of corona-induced deaths in Europe, which remains low compared with March/April. European authorities have introduced in recent weeks restrictions similar to those rolled out in the U.S. over the summer. These restrictions relate to restaurants/bars, gatherings and remote work. Soft lockdowns have replaced hard lockdowns. The pattern of improvement/deterioration will likely be the new normal until a vaccine can put a stop to the pandemic.

In an economic and financial context, it is key whether a new normal approach may break the positive trend in economic growth indicators for good. High-frequency data series in the form of weekly economic activity indices may provide an indication of the most recent trend. In the U.S., the positive trend of the late summer appears to have returned after a sideways movement in July. In Germany, the positive trend continued at high speed until mid-September after which the rate of increase started to flatten. Last, but not least, there are signs that China is undergoing a more broad-based economic recovery, largely driven by positive momentum in the service sector. This means that on a global level, Goldman Sachs's so-called Global Current Activity Indicator (which measures the growth signal in the major high-frequency activity indicators for the U.S. economy) is up for the fifth consecutive month – albeit at a rate of increase trending downwards over the summer. This is in step with a reopening process, which was particularly powerful around the turning point in the early summer, and which is gradually flattening as more areas of the economies have been included the process.

Investment conclusions and asset allocation

In recent months, the development in the financial markets has again shown that *changes* to the economic momentum play a more important role than the *level* of economic activity when it comes to risk premiums and return patterns. As mentioned above, economic indicators have regained positive momentum as societies have been reopened, meaning that some of the recovery potential has already been realised, pushing certain leading indicators nearer to a peak.

However, more strategically and in the longer term, the corona crisis led to a dramatic increase in unemployment in the OECD area to 8.8% in the course of the spring. Since then, unemployment has dropped marginally to 7.7% in connection with the reopening of society. The economies are now considered to be in an "early cycle" position. Most notably, the job market has moved between two positions, "late cycle" and "early cycle", in just a matter of weeks. During normal economic cycles, movements like that usually are realised over a period of several years. "Early cycle" positions share common features. They are typically characterised by large idle capacity at production level. Against this background, the

coming years are likely to be characterised by low investment activity and modest wage growth. This aspect is indeed expected to have a crucial impact on economic policy. Fiscal as well as monetary policy will in coming years be applied proportionally so as to absorb the idle capacity.

As for corona, the coming months are likely to be marked by the new normal, which entails a pattern of improvement/deterioration. Health prospects are unpredictable and broad in scope - and the virus development will undoubtedly still determine the very short-term development of the financial market. A vaccine against coronavirus is getting closer with eleven drugs now undergoing phase III clinical trials. Best case, the first test data will be available in Q4 and published within a foreseeable future.

If new normal entails low risk of hard lockdowns and results in a prolonged highly lenient economic policy, together with an intensified and advanced vaccine development, this will mean that the prerequisites for economic growth are in place. The tactical overweight of equities vs government bonds/covered bonds is maintained. In early June, this allocation was highlighted by a tactical preference to European banks. Historically, the sector has yielded the highest return when the OECD's Composite Leading Indicators (CLIs) rise from low levels.

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